THE NATIONAL CITY BANK OF NEW YORK

1951

Monthly Letter on Economic Conditions Government Finance

New York, December, 1951

General Business Conditions

THERE has been no pronounced change in the business situation in November. When all the returns are in, it will probably be seen that industrial production and employment, supported by the intense activity of the heavy industries, have held about on a par with previous months. Commodity price movements have been narrow. Retail trade reports on the whole have been better, but current demand is supplied in part out of inventories. Manufacturers of consumers' goods generally still find business slow. In the lagging soft goods industries the influences which in due course will bring a recovery are clearly at work, and a better feeling is developing. Markets, however, show only a modest improvement. A sharp cut in the government's estimate of the cotton crop had less stimulating effect on goods buying than was at first thought likely.

The Christmas shopping season holds even more than the usual interest this year. Merchants, and their suppliers as well, count on it to complete the clean up of excess stocks accumulated as a result of heavy commitments made last spring and the subsequent failure of retail sales to increase as expected. Toward this end, much progress has already been made. The seasonal rise in inventories this fall has been less than usual. Commitments have been cut drastically, in comparison not only with last year but with the more normal conditions of two years ago, and the total merchandise position — stocks plus orders — is steadily being brought back in line with sales. Chain stores and mail order houses had a good October, and department store sales in November have shown a greater than seasonal increase. Merchants believe Christmas business and January clearance sales will be good. Stocks in the apparel trades also are being reduced.

The textile readjustment has fallen heavily on the primary producers, whose orders have dropped and stocks increased. The common opinion is that stocks must be reduced further before an upturn in mill operations will be warranted, but mills are encouraged by the evidence that the correction is making headway. It was always expected that the adjustment period, while sharp and painful, would be shortened by the high level of consumer purchasing power. In overall terms the country is enjoying overfull employment despite the layoffs or short time in consumers' goods industries. These industries gain support from the employment given by the heavy industries and producers of basic commodities, expanding outlays for defense, and the huge farm income derived from large crops and good prices.

The Lag in Defense Production

Business sentiment and buying policy remain conservative, not only because inventories have been built up and fears of shortages eased even in hard goods, but because other elements of uncertainty are asserting themselves. One of these is the lag in defense production. Another is the progress toward an armistice in Korea. A third is the growing tendency to question the

CONTENTS

prospect over the long run, i.e., when building falls off, plant and equipment expenditures decline and the defense program goes "over the hump". The last question looks some distance ahead, but it is affecting sentiment on the theory that the shadow will appear before the event.

That there is a lag in defense production behind schedules or expectations is clear. This lag may warrant taking something off of earlier estimates of industrial production over the next few months. However, it may also extend the support of defense demands further into the future.

The causes of the lag are various. Original schedules may have been impracticable, or failure to maintain them may be due to hitches in military procurement. The military are reluctant to freeze designs, for fear of obsolescence. Shortages of materials should not be a bottleneck, considering the government's powers of allocation, but evidently they are in some cases. Machine tool scarcities are a real bottleneck, attributable to materials problems, to restrictive pricing policies enforced in the earlier months of price control, and to the huge size of the program. This bottleneck has set back aviation procurement greatly.

But lags due to such causes do not imply curtailment of the program. Except for the reluctance to freeze designs the intent is not to slow production, but to expedite it. Mr. Wilson and his staff work unremittingly to that end. Cutbacks in materials for consumers' durable goods in the first quarter are severe; the maximum supplies permitted are 50 per cent of the steel, and 35 per cent (even less, in many lines) of the aluminum and copper used during the base period, which is usually the first half of 1950.

In interpreting recent reports of cutbacks in defense totals, it is easy to confuse authorizations, appropriations and expenditures. Additional money to be asked of the next Congress will be smaller, so much of the program having already been authorized. But more than $100 billion has already been appropriated or authorized, and funds are provided for the contemplated increase of some $25 billions, annual rate, in spending over the next twelve months.

If a Korean armistice is negotiated the extra consumption of actual conflict will be eliminated and the freezing of designs perhaps slowed up even more, thus further delaying mass production of finished weapons. This Letter pointed out last month, however, that the effort to get plants equipped and ready and to expand facilities for producing the necessary raw materials would not slacken, and the disclosures concerning the inferiority of the airplanes being used in Korea emphasize the urgency of getting newer models into quantity production. Only the lesser part of the armament program is to meet the requirements of the Korean war. The fundamental objective is to make ourselves strong enough to preserve peace.

Benefits of Skepticism

Taking into account the probable defense outlays, the enormous unfilled orders of the heavy industries, and now the chances for improvement in soft goods perhaps in early 1952, a period of sustained and possibly higher industrial activity, with corresponding employment and flow of purchasing power, is indicated for the months ahead. In the circumstances it is fortunate that some people entertain doubts as to the outlook and that buyers are conservative. In a time of inflationary dangers a degree of skepticism is healthy and salutary. The weakness of unanimity was demonstrated as recently as the beginning of 1951, when almost everyone feared shortages and expected higher prices. The effect was to inflate demand and push the boom to the excesses for which the industries most affected have been paying since.

The stability of prices over the past few months is immensely gratifying. It is attributable to many causes, but among them a high place must be accorded to the soberness with which so many people have regarded the outlook; and to their understanding that the stupendous productive resources of this country make even an armament program of this magnitude manageable, if people only conduct themselves with restraint and accept the moderate degree of self-denial that is needed.

Wage Stabilization Attacked

The outstanding exception to the policy of restraint which has appeared during the past month is the action of the C.I.O. in its national convention in declaring by resolution, amid fiery speeches which used even stronger language, that it would not conform to the Administration's wage stabilization policy. The significance of the action is the demonstration that the United Steel Workers of America, whose wage contracts with the steel companies expire at the end of this year, will not be satisfied with the moderate increases which they would be allowed under the present formula of the Wage Stabilization Board. The formula has been eased repeatedly, in the interest of increasing wages, since the first version was announced last February. But, as one of the union officers flatly declared, the union is out not to bend the formula, but to break it. If it does so higher steel prices must

follow, the increase in wages and costs will go the rounds of industry, and the inflation spiral will take another turn.

A courageous protest against the C.I.O. policy was made by Mr. Di Salle, the Price Administrator, who told the union representatives on the convention floor that they could not increase their "slice of the nation's pie" without upsetting the stabilization program. He declared that strong unions had to temper their pay demands in this defense period, and also disposed of the argument that employers could absorb them. He said:

> It is obviously impossible to base wage policy under controls upon the strength or weakness of unions. Neither can wage policy be based upon the employers' ability to pay. If wage increases are granted only where employers can absorb them without price increases and denied where price increases would be required, all equity disappears from wage policy.
>
> Actually, if excessive wage increases are granted in industries where employers can absorb, it is impossible to prevent similar wage increases in other industries where employers may be unable to absorb. Thus, an excessive wage increase, granted in an industry which does not require price relief, either creates injustice if other unions are held down, or leads directly to inflationary price increases in other areas.

Secretary of Labor Tobin told the same convention that the wages of 20 million workers (mostly not union members) had lagged behind the cost of living since January, 1950. This was presented as an argument for more unions, but may also be taken as a demonstration of the truths cited by Mr. Di Salle. The action of strong unions in forcing up costs and prices caused hardship not only to the 20 million, but to retired people living on pensions, annuities or bond interest, and to everyone dependent on fixed incomes. The Secretary's statement shows the inequities of inflation, to which the C.I.O. is nevertheless determined to give a fresh impetus. If all had the wage increases which the steel union demands, what would be the level of costs and prices, and who would gain?

Shrinkage of the Dollar

By the standard of the Bureau of Labor Statistics' index of consumers' prices, the purchasing power of the dollar has shrunk by 47 per cent since prewar 1939. This shrinkage in the dollar has been a matter of common observation. Most painfully aware of it are older people living on pensions, insurance proceeds, or money they have saved up. Universities find themselves threatened by the shrunken value of their endowment incomes. Trade unions cite increased living costs to back up demands for more pay, and "escalator" clauses, being written into more and more wage contracts, call for pay adjustments when the Bureau of Labor Statistics' index changes. Dollar profits of business, swollen by fictitious inventory gains and by the inadequacy of depreciation charges to cover replacement costs, give a distorted measure of prosperity as do the huge figures on wage and salary payments, national income, and so on.

The saver, however, is less apt to indulge illusions of prosperity. He ruefully compares the 2 to 2.9 per cent he can get on government bonds with the 5 per cent a year average rate of shrinkage he has been experiencing in the value of his money. Savings institutions competitively are increasing interest rates offered depositors, within the modest limits of what they can earn under the government's "easy money" policies. People reconciled to a dollar of wasting value look around for real estate or other equity investments as a hedge against price inflation and dollar shrinkage.

Even worse than an actual loss in the value of money is a contagion of fear that loss of value, under some inexorable force or another, is going to continue indefinitely. Some people today are contending that precisely this is going to happen, and there is considerable force in their argument. Good money has always been a hallmark of national strength and solvency. It is an essential foundation to the position of the United States in the world today, as it is to economic order, progress, and justice. Thus when money loses value, and people say that it is going to keep on losing value, there are erosive forces at work. It is important to observe what these forces are.

Good Money and Bad

Fluctuations in the buying power of money are familiar over all history. Gold has had the best record over the centuries as a store of value. Paper money has been good when issued by banks which have been under a legal obligation to maintain convertibility into gold at the option of the holder. The old pound sterling and the old U. S. dollar were currencies of this type; their very names became synonymous with enduring value. Paper money directly issued by National Treasuries has the worst record, though money can be just as bad if it is put out by a bank of issue which is free from the necessity of maintaining gold convertibility and bends to the wishes of a profligate government for cheap financing. Most of the worthless currencies issued in foreign countries during and after the war bore the stamp of a corrupted central bank of issue.

With the sole exception of gold coin, the pound sterling and the U. S. dollar have held their value better than most other currencies over the past century and a half. Numberless national currencies over this period have tumbled to worthlessness. The pound sterling in 1913, if anything, would buy more than it did a century earlier, and the same held true of the dollar. The pound, sheared from the gold standard in 1931, will buy about one-third as much today as in 1913, and its value is further impaired by stringent regulations on its use by the holder. The dollar, devalued against gold in 1934, will buy in consumers' goods 38 per cent as much today as in 1913. (In either the British or the American case, the value of an *earned* pound or dollar is further reduced by the innovation of steeply progressive income taxes.)

The Record of the Dollar

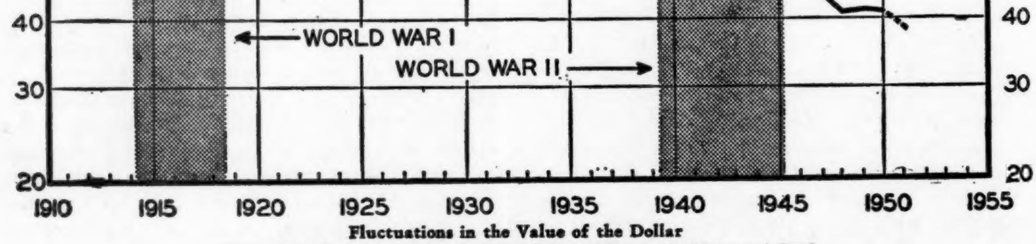
The chart at the bottom of the page gives a record of the buying power of the dollar since 1910, with the dollar of 1913 taken as 100 cents. As the chart shows, there are two extended periods of decline in the value of the dollar and one of rise. The outbreak of World War I in 1914, like every other major conflict in history, brought price inflation and was followed by more inflation culminating in 1920. The dollar then was down to 50 cents in terms of the 1913 dollar. Post-war price deflation brought a recovery to 59 cents and the value held in the range of 56 to 59 cents during the prosperous 'twenties. The great depression raised the value of the dollar, in 1933, to 77 cents. Since then it has shrunk in 15 years out of 18. The 1951 dollar is worth 38 cents in comparison with a 1913 dollar of 100 cents, and 53 cents in comparison with a 1939 dollar.

The common explanation of the shrinkage since 1939 is World War II. This was the cheapest war in our history in terms of the rates of interest paid by government on borrowed money; by the same token it was the war in which the least financial inducement was offered to promote saving and the greatest reliance was placed on inflationary borrowing from the Federal Reserve Banks. The upswing in prices over the past seventeen months was directly stimulated by the Korean war. But there is more to it than that. Professor Sumner H. Slichter of Harvard holds that certain government policies and practices are undermining the purchasing power of the dollar and that we thus have "an inflationary economy."

Government Policies Undermining the Dollar

Professor Slichter has spoken around this general theme for several years, and his apprehensions so far have proved remarkably correct. The following excerpts from a speech he made before the Savings Banks Association of Massachusetts, September 22, bring out the main points in his analysis:

1. The policy of supporting the prices of farm products . . . is particularly important because it affects the price of food, and the price of food affects the wage demands of unions. . . . Parity prices of farm products are so defined that even in June, 1950, when the country was in the midst of a business boom, all six of the so-called "basic" crops were selling below parity and only six out of seventeen other crops included in the price support program were selling above parity. . . . During the present fiscal year, the budget calls for ex-



Fluctuations in the Value of the Dollar
Measured by Bureau of Labor Statistics Index of Prices of Consumers' Goods
1913 Dollar = 100 Cents (Logarithmic scale to show proportionate changes)

penditures of $504 million for price support and related programs. . . .

2. The policy of maintaining "full" or high level employment . . . lessens the likelihood that the price declines of recessions will be offset by the price increases of booms. Consequently, the policy of maintaining or of encouraging full employment is likely to bring about a slow drop in the purchasing power of the dollar.

3. The policy of encouraging employees to organize . . . has resulted in a more than four-fold increase in trade unionists in the United States between 1933 and 1951. Considerably more than half the wage earners in manufacturing, mining, transportation, and construction are union members. The large trade union membership and the great strength of the unions make it likely that wages will rise a little more than output per manhour, which seems to have been increasing at the average rate of about 2.5% per year. . . .

If the government were not pursuing the policy of attempting to maintain a high level of employment, one might question whether the upward pressure of unions upon wages would be inflationary or deflationary. It might be either, but I do not have time to discuss the reasons for this statement. If the government seeks to encourage a policy of full employment, however, the upward pressure of unions on wages will affect prices rather than employment. This means that unions, through their wage demands, are likely to be among the principal makers of fiscal and credit policies — having more influence than the people who appear to make those policies.

What Professor Slichter evidently foresees is that government, by a combination of deficit-financing and easy credit policies, will stand ready to pump out more money whenever business falters, thus attempting to assure a perpetuation of prosperity based on a shrinking money.

A Universal Experience

Aside from coin possessing intrinsic value, shrinkage in the value of money has been world-wide. The losses, going back to 1939, have been highly variable in degree, as the table shows, but the smallest range from 40 to 50 per cent.

Shrinkage in the Value of Money, 1939 to 1951
As Measured by Prices of Consumer Goods
or the Cost of Living

	Per Cent Shrinkage as of June 1951*		Per Cent Shrinkage as of June 1951*
Switzerland	39.5	Colombia	71.6
South Africa	41.6	Argentina	73.4
Sweden	43.7	Spain	73.4
Canada	45.4	Belgium	74.8
U.S.A.	46.1†	Mexico	74.8
United Kingdom	48.5	Brazil	76.3
Uruguay	49.0	Chile	85.3
Australia	50.0	France	94.6
Netherlands	61.5	Italy	98.1
Egypt	68.1	Japan	99.3
India	68.5	Greece	‡
Turkey	71.1	China	‡

* Australia, as of 2nd quarter 1951; Argentina, February 1951; Turkey, Uruguay, as of May 1951.

† 47.0 per cent shrinkage as of October 1951.

‡ More than 99.9 per cent loss.

General Note: Per cent shrinkages are understated in a number of countries owing to the effect of price and rent controls, subsidies on cost of living items, etc.

Source: International Financial Statistics, published by the International Monetary Fund.

In the United Kingdom, where the decline in internal buying power of money has been a little greater than in the United States since 1939, the causes and consequences have become a live topic of discussion. The London Economist recently published a series of articles, prepared by an unidentified correspondent, on "The Age of Inflation." He predicts a gentle and indefinitely long climb in prices and the cost of living, world-wide, as a result of the strength of trade unions (producing upward pressures on business costs), the use of inflationary weapons (budget deficits, cheap money, and devaluations) to achieve full employment, the political shift in all democratic countries to the "left" (with expensive social services provided by taxing the savings of "the rich"), etc.

Among highly inflationary international factors, the Economist's correspondent mentions the end of free trade and the gold standard and "the new habit of inter-governmental charity."

In the past if a country, through inflation or any other cause, was running an unfavourable balance of payments it had to stand on its own feet in the end and check the outflow by deflation. Since the last war, however, inflation in Britain and Europe has been floated off by Marshall Aid and the price level has never had to come down. Similarly Indian inflation may well be floated off by the Colombo Plan. The unfavourable trade balance, in other words, is usually met by a kind fairy from without and the spending spree may continue. Moreover, the act of charity inflates the kind fairy in her turn. . . .

After laying out this bill of particulars, the Economist's correspondent goes on to comment that "it is very difficult to think of any new deflationary factors of any magnitude to set on the other side."

The Escape of Escalation

The Economist's correspondent makes many more specific points than Professor Slichter but both emphasize the irreconcilability of the "full employment" objective with a stable money objective: if government acts to increase its spendings and the money supply every time business and employment fall off — as it were to "reflate" even before any real "deflation" has occurred — the peak levels of prices in successive "booms" are almost bound to move higher and higher. The prospect of chronic inflation, which they hold out, fouls up all sorts of money contracts between people and involves the most serious sorts of economic injustices. Professor Slichter deals with these but does not go much beyond suggesting the wisdom of home ownership, the purchase of common stock, setting a more adequate rate of interest on Savings bonds, and offering a government bond that would have a

redemption value determined by the official cost of living index. The wage-earner, he points out, has protection both in automatic wage escalation and in the fact that inflation makes more jobs than there are people to fill them, producing a natural upward pressure on wages and salaries.

Making Inflation "Comfortable"

The Economist's correspondent deals with the inequities of an inflationary economy in a more comprehensive way. "We have made our inflationary bed and we must lie on it: but we might as well be comfortable."

He would tie wages and salaries to the cost of living, though not too rigidly, and also pensions and insurance premiums and benefits. In calculating tax liabilities and setting prices, corporations and real estate owners would have to be permitted to figure depreciation on a basis of replacement cost instead of actual historical cost. Pointing out the injustice to the poor, helpless to hedge their savings against inflation, he, like Professor Slichter, would have governments offer a bond that would "escalate" in value with the progress of inflation. Income tax exemptions and rates, fines, fees, railroad fares, etc., etc., now determined by law or regulation, would have to be made flexible.

In introducing these proposals, the Economist's correspondent makes no pretense that he has thought of all the injustices from inflation, and he makes no attempt to deal with far-reaching practical problems raised by his prescriptions for making inflation "comfortable". But the general import is that, since money of stable value is fundamental to modern society, the whole structure has to be recast if money is to waste away in value.

Carried through to its logical conclusion, every Constitutional provision, law, regulation, and contract that mentions any sum of money would have to be put on the escalator. These things laboriously accomplished, the fate of the nation would be made to hinge on the skill and integrity of the index number calculators. And there would still be left unsolved the question whether there would be any recognizable credit machinery left — whether lenders would be prepared to lend without escalator protection and whether borrowers would be able to honor escalated liabilities.

The Totalitarian Drift

The greatest merit in Professor Slichter's and the London Economist's discussions is that they draw attention to the sources, in government policy, of inflation. One thing which they do not develop, however, is the tendency for government, abetted by trade union leaders, to shift the blame for inflation to "profiteers" and to attempt to repress it with price controls. When controlled prices become unrealistic and supplies fail, the blame gets placed on "hoarders" and demands appear for government regulations over the disposal of the industrial product and for regimentation of the labor force to see that essential industries are adequately staffed. Again, as inflation swells the credit needs of business, the banks come under criticism for lending too much, and government policing of financial transactions is suggested. Thus totalitarianism insidiously beckons as a path of escape, as though government which cannot keep its own house in order is fit to be entrusted with powers of dictation over larger spheres.

The London Economist, in comment on its correspondent's articles on "The Age of Inflation", warns that "if anything more than a very gradual fall in the value of money becomes the normal expectation of ordinary people, then there is acute danger ahead for democratic society." What these dangers are have been set forth by the late Lord Maynard Keynes. While his words were written after World War I, they could just as well as have been written today against the background of World War II:

> Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.
>
> Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

Playing with Fire

Professor Slichter expresses the view that there is a "limit of tolerance" on dollar depreciation of perhaps 3 or 4 per cent a year. At 3½ per cent, compounded, the price level would

double — and the dollar lose half its value — every twenty years. Beyond that, he apprehends, people might be panicked into converting money into goods, precipitating runaway inflation.

Whatever the merits of this evaluation, there is no question that any government that is playing with inflation is playing with fire. A government which embarks upon inflation as a course of policy, and offers guarantees against loss from inflation, impeaches its own credit. How, except by taxation, can a government ultimately make good on such guarantees? If taxation is stretched to the limit they can be met only by printing up more money and accelerating inflation. The more escalation schemes in operation, the faster the flames will spread.

There are times, to be sure, when a nation, under stress of overwhelming emergency, must take recourse to inflation. The United States did so during the Civil War, World War I, and World War II. In the first two cases, the move was taken with reluctance, and the nation accepted the pains of postwar deflation to restore the strength of the currency. In the case of World War II there was a feeling — born of the depression — that some currency inflation might be a good insurance policy for postwar prosperity. From that standpoint of creating abundant employment opportunities — and rising prices — it worked.

But from the standpoint of the creditor — the buyer of Savings bonds, the pensioner, the insurance beneficiary, the school teacher with lagging pay — the experience during and since World War II has been disheartening. Inflation is a concealed type of tax and these are the people who took the brunt of it. Postwar inflation has compounded the injury.

Postwar inflation actually may have created more human tragedies than a spell of deflation might have done. Ironically, in this day of emphasis on old-age security, shrinkage in the dollar strikes hardest at people past their working years, as well as people in their working years providently preparing for their future family security. It strikes at all of our institutional arrangements founded on the presumption of a sound currency.

To the economic planner a little inflation seems a fine idea. As Alfred Marshall, the celebrated British economist, pointed out sixty-five years ago, it deceives working people into thinking that they are better off than they really are. The longer it takes them to wake up to what is going on, the harder the inflation is to stop, the more damage is done in the process, and the worse the mess to straighten out when the day of reckoning comes.

Toward a Stable Money

In 1933, when the dollar was being intentionally depreciated in an effort to drive prices up, President Roosevelt informed the World Economic Conference meeting in London:

> Let me be frank in saying that the United States seeks the kind of dollar which a generation hence will have the same purchasing power and debt-paying power as the dollar value we hope to attain in the near future. That objective means more to the good of other nations than a fixed ratio for a month or two in terms of the pound or franc.

The Gold Reserve Act of 1934 repudiated the obligation of the Federal Reserve Banks to maintain unrestricted gold convertibility, as well as the right of the American citizen to hold gold, and cheapened the dollar 41 per cent in terms of gold. It took fourteen years — including a major war — for the dollar to lose 41 cents of its value in terms of consumers' goods. But the shrinkage did not stop there. It has kept on. Government policy-makers no longer give assurances that the dollar is going to hold its value, generation after generation, even barring major war. The worthy purpose Mr. Roosevelt stated was not, and demonstrably could not be, achieved by monetary manipulations. A stable dollar stands beyond reach so long as recourse is taken to fresh outpourings of public funds, excesses of cheap credit, price supports and subsidies every time the economy falters under the weight of excessive taxes or wage demands, or adjusts itself to changing consumer preferences and market conditions.

So far as gold policy is concerned, the forecasts of a shrinking dollar presume devaluations against gold as a matter of course, whenever the need arises to keep the inflation going. The simplest action government could take to rebuild faith in money, and to dash these grim expectations, would be to rewrite the Gold Reserve Act of 1934 so as to reaffirm and strengthen the present tie of the dollar to gold, and to shut the doors on the dangerous notion that the chief function of the Federal Reserve Banks is to provide cheap and depreciating money for government to spend and lend.

The Reviving Role of Interest Rates

Action by the Bank of England last month in advancing its discount rate from 2 to 2½ per cent, and in taking other steps to tighten credit, may be said to mark the end of an era of monetary philosophy. To quote the London Economist of November 10 —

Very wisely, the new Chancellor has lost no time in enlisting, for his attack upon inflation, the almost forgotten technique of orthodox monetary policy. He has raised Bank rate — a rate kept unchanged and wholly ineffective for so long that it had come to be regarded by some people as a kind of museum exhibit from an obsolete system.

The British action is only one of a series of steps in different countries indicating a reviving recognition of the role of interest rates and credit policy in influencing production, employment, and prices. An earlier step of epochal importance was the unpegging in this country of the government bond market last March, untying the hands of the Federal Reserve to exert its traditional controls over the volume and cost of credit.

The falling into line by the Bank of England, one of the last of the central banking institutions to take such action, and for many years the leader in the money markets of the world, comes as culminating evidence of the trend toward monetary orthodoxy. It marks the end of the era of faith in the doctrine that money ought always be kept easy and interest rates low, regardless of the state of the economic climate.

The Cheap Money Philosophy

This faith in the efficacy of perpetually cheap money had been something new in man's economic thinking. Like so many other recent departures from traditional economic theory, it sprang from the great depression of the '30s.

Prior to 1929 there was little disposition anywhere to question the idea of fluctuating interest rates. Changes in such rates were commonly accepted as one of the instruments of credit policy. As Dr. Per Jacobsson, Economist of the Bank for International Settlements, pointed out in the April 1951 Quarterly Review of the Skandinaviska Bank (Stockholm) —

> The successful operation of the world's currency systems under the gold standard depended very much on the flexibility of interest rates: one of the advantages of this standard was that gold movements could as a rule be taken as a guide for policy, since they generally reflected the state of the balance of payments and of the internal credit situation. And, at the same time, the example set by the London market was of the greatest importance, changes in interest rates by the Bank of England being looked upon as indicative of the general world trend.

The depression of the '30s, however, wrought great changes in the thinking about interest rates and credit policy. While it had always been established doctrine that interest rates should be low during periods of declining business, there developed out of the length and severity of the depression a new school of thought which held low interest rates to be a blessing, the enjoyment of which ought not be limited to periods of depression but extended to all times, good as well as bad.

Then came the second world war, with its emphasis upon low interest rates for war financing. Altogether, counting the depression and the war period, there existed, as Dr. Jacobsson noted, a span of some fifteen years of continuously cheap money. In consequence of this and the preaching of the new monetary doctrines, belief in the virtues of cheap money continued to flourish even into the early postwar years. As indicated by the Economist, many people came to regard the discount rate as little more than an interesting relic of an outmoded age.

Belgium was one exception to the trend, the National Bank twice raising its discount rate in 1946. This was in keeping with the independent course taken by that country in dealing with its postwar economic problems.

Cracks in the "Party Line"

Gradually, however, faith in the cheap money gospel began to wane. Already in 1947 there appeared cracks in the "party line".

In the autumn of that year, Italy, under the leadership of Professor Einaudi, Governor of the Banca d'Italia and Finance Minister, instituted a program of financial reconstruction, involving a higher discount rate along with other credit restrictions. Long-term interest rates were permitted to find their own level, going as high as 7 to 8 per cent. Thanks to these and other measures, inflation was arrested and prices even brought down somewhat. All this was notwithstanding the necessity of the Treasury to provide for a substantial budget deficit.

Also in the autumn of 1947 the Bank of France increased its discount rate in conjunction with other restrictive credit measures. This was followed by still firmer measures the ensuing year. There, as in Italy, the long-term interest rate rose to around 7 per cent.

It was likewise in the autumn of 1947 that the British financial authorities abandoned the attempt to keep the long-term interest rate at 2½ per cent. While allowing the long rate to fluctuate, they continued to peg the short-term rate at low levels. In this respect, the British policy differed from that followed until recently in this country, which was to permit the short-term rate to rise, but to peg the long-term.

In Sweden there was growing controversy during 1948 over the government's policy of supporting its own bonds through Riksbank purchases, leading to the resignation of the Riksbank's governor, Mr. Ivar Rooth, in protest.

It was not, however, until July 1950 – after Korea – that the policy was modified.

Influence of Korea

It remained for the outburst of inflation after Korea to speed the movement towards higher interest rates. The inflationary process generated pressures making it more and more difficult to hold interest rates in check. Like King Canute of old, the money managers found themselves dealing with tides beyond their powers to command.

For, in the first place, inflation eats up capital. With inflation it takes more money to finance current business and capital improvements. The saved dollar, or pound sterling, or franc no longer buys what it used to. This consumption of capital tends to express itself in higher interest rates.

Secondly, inflation artificially multiplies demand, creating powerful upward thrusts on interest rates – the price of money – just as it does on wages and commodity prices.

Thus one country after another, in the inflationary aftermath of Korea, discovered the impracticability of trying to contain these tremendous forces while at the same time feeding inflation with continuous outpouring of credit in the effort to hold interest rates down. This is shown by the following table listing central bank discount rate changes since Korea:

Changes in Central Bank Discount Rates Since Korea

Country	Date of Change	New Rate (Per Cent)	Change from Previous Rate
Denmark	July 4, 1950	4½	+1
	Nov. 2, 1950	5	+½
U.S.A.	Aug. 18, 1950	1¾	+¼
Belgium	Sept. 11, 1950	3¾	+½
	July 5, 1951	3½	−¼
	Sept. 13, 1951	3¼	−¼
Netherlands	Sept. 26, 1950	3	+½
	Apr. 17, 1951	4	+1
Canada	Oct. 17, 1950	2	+½
Germany	Oct. 27, 1950	6	+2
Finland	Nov. 2, 1950	7¾	+2
Sweden	Dec. 1, 1950	3	+½
Turkey	Feb. 26, 1951	3	−1
Chile	Mar. 28, 1951	8	+2
France	Oct. 11, 1951	3	+½
	Nov. 8, 1951	4	+1
United Kingdom	Nov. 8, 1951	2½	+½
India	Nov. 15, 1951	3½	+½

The table shows twelve countries which have increased their central bank discount rates since Korea, with three – Denmark, the Netherlands, and France – increasing their rates twice. Belgium again provides a unique case, that country following a rate increase in September 1950 with two successive reductions this year, reflecting that country's creditor position in the European Payments Union and apparently an endeavor to facilitate the financing of increased imports.

At the same time long-term interest rates have been allowed to rise further in many countries. In the United States, the longest-term Treasury marketable 2½s of 1967-72 declined last month to a new low of 96½ at which the yield approximated 2¾ per cent. In England the British Government 2½ per cent bonds declined into the 60s to yield about 4 per cent, against prices at par during the peak of the cheap money drive shortly after the close of the war. In Canada, the long-term government bond market, which had been permitted by the Bank of Canada to decline by intermittent stages, experienced a further drop of 1½ points last month, the 3s of 1966 going to 95½. Fitting into the same pattern, in Australia this summer the rate offered on government bonds was advanced from 3⅛ to 3¾ per cent.

Dearer Money in England

Though the rise in the Bank of England's discount rate has been widely regarded as the chief symbol of a firmer British money policy, actually it was less important than other measures taken to make the new policy effective. The really significant rate in England in recent years was not the so-called Bank rate, which applies to loans against approved commercial bills and bonds, but the rate at which the Bank, acting through its agent, or "special buyer", was willing to purchase Treasury bills.

Since 1945 this Treasury bill rate has been held rigidly pegged at ½ per cent. Thus the market has been able to obtain almost unlimited accommodation by the simple process of selling bills to the Bank, through its "special buyer", at the pegged rate.

The new program abandons this rigid system for one in which the "special buyer" will buy bills only in such amounts and at such rates as the Bank of England believes justified. For the remainder of its needs, the market will have to go to the Bank itself and borrow, for a minimum period of seven days, paying either a newly-established rate of 2 per cent against Treasury bills, or the regular discount rate now raised to 2½ per cent on other eligible paper.

In other words, in place of the recent system in which the market – and through it the banks – could rely upon more or less automatic access to central bank credit to meet larger loan demands, the new program calls for a return to the prewar system in which the terms and conditions of obtaining additional funds were at the discretion of the central bank. The Bank of England's action in unpegging the Treasury bill rate is thus similar to the Federal Reserve's action in unpegging U.S. Treasury bonds, and was taken for the same purpose of enabling the central bank to recover control over its own operations and escape the role of a passive agent of inflation.

A decision to fund £1 billion of British Treasury bills into one-, two- and three-year bonds is likewise part of the disinflationary program. Officially stated to be for the purpose of reducing the floating debt to "more manageable proportions", the move will have also the effect of reducing the proportion of very short-term securities in total bank assets. With a lower liquidity ratio and a tighter official hold on the volume of bank cash, the banks may be brought nearer to the stage at which further increases in loans would entail a reduction in holdings of investments. This would mean added pressure on the banks to withhold additional credit, particularly if the granting of such credit would involve selling securities at a loss. This comes on top of a plan of voluntary credit restraint something like our own.

The effect of these operations upon the London money market has been to bring about a fractional stiffening in short-term interest rates. The market, however, is in a state of transition and it remains to be seen how far the authorities will press their program. Meantime, investors are taking a cautious attitude, reflected both in the decline in prices of outstanding gilt-edged securities and in the poor reception accorded a large new private security issue.

In attempting to estimate the effect of the new policies it must be realized that it is not so much the higher interest rates themselves that count as it is the lessened availability of credit which the higher rates signify. So long as lenders find their resources constantly replenished by a flow of central bank credit pumped out for the purpose of keeping money cheap, they have little incentive to refrain from following an expansive lending policy. But when access to central bank credit is tightened up, lenders tend to be more "choosey" with respect to new commitments. In this way, policies involving only moderate increases in interest rates can often exert a relatively powerful influence in curtailing credit expansion and hence inflation.

Thus in one specific way the British have undertaken more vigorous resistance to the inflationary trend reviewed in the preceding article.

Industry's Balance Sheet Expands

Assets of manufacturing corporations, following two periods of great expansion during World War II and the postwar boom, have experienced a third wave of expansion to new high levels since the outbreak of war in Korea. The heavy investment of capital in new and modernized plant and equipment brought about a large increase of industry's property account, while the step-up in dollar volume of business caused a building up of inventories and receivables, and to a lesser extent of cash and government securities.

This rise in dollar valuations of fixed and current assets was caused partly by the real increases that have been made in physical output and in productive capacity, and partly by the wartime and postwar inflation of labor and material costs and the consequent decline in purchasing power of the corporate dollar. As a result of the turnover of assets that has occurred during recent years, the balance sheets being issued currently reflect to a growing extent the replacement of low-cost prewar assets with much higher-cost postwar assets.

To the extent of the price mark-up, both the reported good earnings and the increased balance sheet valuations are in a sense illusory and represent overstatements. Moreover, because of the record-breaking amounts of capital now tied up in swollen inventories, the apparent increase in overall financial strength has not, unfortunately, been accompanied by a corresponding rise in liquidity.

The sweeping changes that have taken place in the book assets of American industry may be seen from the following composite balance

All Manufacturing Corporations in the U.S.

(In Billions of Dollars)

Assets	Dec. 31 1940	Dec. 31 1945	Dec. 31 1948	June 30 1950	June 30 1951
Cash	$ 5.7	$11.3	$11.8	$12.0	$12.9
Government securities	1.1	11.0	7.5	10.7	12.4
Receivables net	8.4	13.6	17.1	14.1	18.1
Inventories	12.3	17.3	30.4	26.7	35.9
Other current assets	*	*	*	1.4	1.8
Total current assets	27.6	53.1	66.8	64.8	81.2
Plant and equipment	42.7	53.9	74.0	*	*
Less depreciation	19.1	28.7	32.8	*	*
Net property	23.6	25.1	41.2	41.9	46.3
Other investments	8.2	10.1	11.1	*	*
Other assets	1.1	2.7	2.6	8.3	8.9
Total assets	60.5	91.0	121.7	115.0	136.5
Liabilities & Capital					
Accounts payable	5.3	8.3	11.4	7.8	10.5
Notes payable	2.0	2.7	3.9	2.1	4.3
Federal income taxes }	3.7	9.4	10.6	6.7	18.1
Other current liab. }				4.6	5.5
Total current liab.	11.0	20.5	25.9	21.3	33.4
Long-term debt	5.4	6.4	11.8	11.3	12.6
Reserves	*	*	*	2.7	2.5
Capital and surplus	44.2	64.2	84.1	79.8	88.0
Total liab. & capital	60.5	91.0	121.7	115.0	136.5
Net Working Capital	16.6	32.6	40.9	43.5	47.8
Ratios:					
Current assets to current liabilities—%	252	259	258	305	243
Cash & govt. securities to current liabilities—%	63	109	75	107	76

Sources: Treasury Department annual Statistics of Income and S.E.C.-F.T.C. quarterly estimates. * Not reported separately.

sheet of all U.S. manufacturing corporations, numbering around 117,000. Figures for December 1948 are included because that was an intermediate high point, followed by temporary liquidation through the year 1949 and early '50.

Over the entire period covered by the table the total assets of all manufacturing corporations were expanded from approximately $60 billion in 1940 to $136 billion in June 1951, or to more than double. Over half of the expansion was financed by the building up of capital and surplus, from $44 billion to $88 billion, largely from the balance of net income retained after payment of dividends. The remaining $32 billion came from increases in accounts and notes payable and in tax reserves, plus some long-term borrowing.

The increases in inventories and receivables, plus cash and government securities, far exceeded the increases in current liabilities, so that net working capital rose from $17 billion to $48 billion, or to almost treble.

During the year following the Korea outbreak in June 1950, industry's total assets expanded by $21 billion. Although net working capital continued to rise, the ratio of current assets to current liabilities declined from 305 to 243 per cent. Cash and government securities alone declined – as the S.E.C.-F.T.C. study pointed out when presenting its latest estimates – from 107 to only 76 per cent of current liabilities.

Plant Expenditures vs. Depreciation Charges

The net property account, representing gross value of plant and equipment including land, but after deduction of accrued reserves for depreciation, of all manufacturing corporations increased during the 10½ year period by approximately $23 billion or almost 100 per cent. Among the industries leading in this rebuilding program were steel, automobiles, machinery, food products, chemicals, and petroleum.

Even this large expansion in property account was exceeded by the expansion that occurred in dollar volume of sales, which rose from $67 billion in 1940 to an annual rate of $213 billion in the first half year 1951 or by 220 per cent. An increase in output so much larger than in plant capacity might seem hardly possible, yet the fact remains that it was accomplished – the explanation being that capacity was used to a fuller extent, that capacity increased far more than the depreciated book valuations at which it is carried on corporate balance sheets, and that sales were recorded in current dollars of falling purchasing power.

For all manufacturing corporations, the combined charges for depreciation, depletion, and amortization of defense plant facilities have risen from $1.7 billion in 1940 to an annual rate of over $4 billion in the first half year 1951, as shown in the summary below. Since these charges represent a cost item involving no cash outlay, they are becoming an increasingly important internal source of corporate funds.

Annual Charges for Depreciation, Depletion, and Amortization of All U.S. Manufacturing Corporations

(In Millions of Dollars)

Year	Depreciation	Depletion	Amortization	Total Charges	Net Property Jan. 1	% of Property
1940	$1,530	$ 196	$ 6	$1,732	$23,060	7.5
1941	1,632	221	89	1,942	23,606	8.2
1942	1,754	287	309	2,350	24,727	9.5
1943	1,826	369	534	2,729	26,606	10.3
1944	1,825	424	741	2,990	27,037	10.1
1945	1,827	428	1,285	3,540	25,922	13.7
1946p	1,909	507	34	2,450	25,145	10.1
1947p	2,352	751	25	3,128	29,413	10.6
1948p	2,808	1,057	10	3,875	35,380	10.9
1949e	*	*	*	3,601	41,227	8.7
1950e	*	*	*	3,929	41,091	9.5
1951ae	*	*	*	4,200	43,765	9.6

Sources: Treasury Department annual Statistics of Income and S.E.C.-F.T.C. quarterly estimates. a Annual rate for first half year. e Estimated. p Preliminary. * Not reported separately.

During the six-year period between December 1945 and December 1951, American business, other than agriculture, will have invested $109 billion on the expansion and modernization of its facilities for meeting the demands of the country's growing population plus the national defense program. Of this total, the manufacturing industries contributed $50 billion or almost half, the remainder comprising the railroads, electric and gas utilities, telephones, mining, trade, and service industries.

These vast capital outlays have had the effect of swelling greatly the gross property accounts as carried on corporate balance sheets. They have tended also to adjust upward the gross book valuations, by reflecting more of the inflated levels of wartime and postwar costs and less of the lower price levels that prevailed prior to 1940.

At the same time, the annual depreciation charges have served as a substantial offset to the expansion in gross property account. Net property account as carried on the books after deduction of depreciation reserves still lags far behind present-day replacement costs. This means a continued understatement on the balance sheet of the real value of shareholders' equity, and a corresponding overstatement of the real rate of return computed thereon.

S

NK
S

n U.S.A.